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TAGS: ECON EFIN EINV ENRG EAGR IN
SUBJECT: MUMBAI ECONOMISTS DISCUSS NEXT STEPS NECESSARY TO COUNTER
THE ECONOMIC SLOWDOWN

MUMBAI 00000273 001.2 OF 004

¶1. (SBU) Summary: On June 16, a group of leading economists in Mumbai discussed possible economic reforms by the newly-elected Congress-led government. All economists agreed that the mood in the Indian economy is currently buoyant and confidence ruled. Nevertheless, they cautioned that timely government action to prove itself capable of tackling the economic slowdown is crucial; otherwise all economic exuberance would evaporate. They pointed to the mobilization of savings to productive investment, the development of the debt market to provide long-term project finance, and joint and coordinated government-agency action as crucial drivers of economic growth during the global economic slowdown. Most economists did not believe that the new government would rush to push big-ticket reforms which, they admitted, would accelerate foreign investor interest in India. The Congress Party, although re-elected to lead the new government, still has to depend on unreliable and unpredictable coalition partners who may be reluctant to lend support to initiatives which would boost the economy but not necessarily endear them to the common masses. End Summary.

¶2. (SBU) On June 16, CongenOff and U.S. Treasury Attachi to India hosted lunch for a group of leading economists in Mumbai to discuss the recent upswing in economic confidence and forthcoming economic reforms following the Congress Party's victory in the national elections. Economists who attended the lunch include Atsi Sheth, Chief Economist for Reliance Capital; Jyotivardhan Jaipuria, Head of Research for DSP Merill Lynch; Siddhartha Roy, Economic Advisor for Tata Services; Indranil Pan, Chief Economist for Kotak Mahindra; Sachchidanad Shukla, Economist for Enam Securities; Sonal Varma, Chief Economist for Normura Financial Advisors; and Ajit Ranade, Group Chief Economist for the Aditya Birla Group. Jeff Glekin, Deputy Head of the British Deputy High Commission also attended the roundtable.

Possible Reforms by the Newly-Elected Government
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¶3. (U) All interlocutors agreed that there has been an obvious "boost of confidence" since the United Progressive Alliance with the Congress at the helm was re-elected. According to Ajit Ranade of the Aditya Birla Group, the "positive" sentiment fueled by the stock market uptrend has changed the economic landscape in India, and will hopefully translate to increased investment. However, Sonal Varma of Nomura Financial Advisors, pointed out that the market perception of needed economic reforms is different from the government. Varma observed that the positive feeling in the economy since the election results has since dissipated and risk aversion is back.

¶4. (U) Among the possible reforms is de-regulating the prices of petroleum-products in India to enable the market and not the government to determine the price of fuel sold to consumers. Sachchidanand Shukla of Enam Securities who studies the oil and gas sector, believes that market-determined pricing of petro-products is unlikely to become a reality in the near-term. He noted that government-owned oil marketing companies in India are profitable only if crude oil prices are below $65 a barrel, otherwise they lose money. These companies will, therefore, immediately hike petrol and diesel prices if de-regulation is implemented as crude oil prices are now hovering at $70 a barrel. Consequently, consumers will have to pay more at the pumps, making de-regulation an unpopular move in the current scenario, he explained. This reform can only be implemented when there is a sustained downtrend in crude oil prices, he said. Shukla admitted that the doubling of crude oil prices in just 75 trading sessions was perplexing, especially since the demand for oil is at its lowest since 1982. He opined that financial speculation due to excess global liquidity was driving prices up. Roy of Tata Services added that other precious



commodities, particularly aluminum and cooper has also seen similar unexplained price increases.

¶5. (U) On the controversial topic of disinvestment, Atsi Sheth of Reliance Capital noted that the Government of India (GOI) mainly sees it as a vehicle for one-time revenue raising. The GOI needs to give up management control and privatize, rather than merely disinvest, especially in inefficient loss-making government-owned companies she added. Piece-meal disinvestment of a 10 percent stake in government companies may not raise a substantial amount if the stock market is depressed, Sheth noted. Roy added that it was important to note that not all government-run enterprises were poorly run; he pointed out that the navratnas (profitable state-owned companies which the government rewards with more management freedom) which he opined were mostly free of political control were as professionally run as many corporations.

¶6. (U) DSP Merrill Lynch's Jyotivardhan Jaipura opined that the pending insurance sector bill to raise the Foreign Direct Investment (FDI) limit from the existing 26 percent to 49 percent is likely the first reform to be passed by the newly-elected government. He, however, did not think any major reforms in the banking sector would follow suit. In any case, he felt that foreign investors are attracted more towards India's government-owned oil companies rather than government-owned banks. Irrespective of whether the government raises the FDI cap in the banking sector, Ranade believes that many public sector banks would consolidate among themselves to streamline operations and improve efficiency.

Free Trade, Higher Savings and Productive Investment cited as

Growth Sustainers

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¶7. (U) Jeff Glekin of the British Deputy High Commission, enquired why there were few calls for protectionism in India. Atsi Seth of Reliance Capital, explained that both the Indian government and industry understand that when trade barriers are raised by one country, other countries reciprocate by raising their own barriers and no one wins. Ranade of the Aditya Birla Group, said that Indian companies were advocates of free trade rather than protectionism with more and more companies going global. He cited the eagerness of Indian companies to bid on contracts in the U.S. that are supported by the U.S. stimulus package as an example of the global expansion plans of Indian companies. Ranade noted that India, currently on the observer status, is three years away from signing the WTO Government Procurement Agreement, which would allow foreign companies to bid on government contracts. However, he admitted that there were questions on whether or not Indian companies could successfully compete against global contractors and whether there was a level playing field for foreign government contracts across countries. Ranade noted that although India is open to foreign contractors, such as the Chinese, foreign companies, including Indian, are shut out of bidding on government contracts in China.

¶8. (U) Responding to a discussion on free trade agreements, Sheth observed that trade agreements are more useful for the small-scale industries, or "unorganized sectors", such as gems and jewelry, and carpets. Larger industries do not really need country-specific trade agreements as they already have global vendor-supplier contracts in place. India needs investments, not trade agreements, she concluded. Indranil Pan of Kotak Mahindra Bank, added that in addition to investment, India needs more productive channeling of household savings. Although savings in India is increasing (Note: India has one of the



highest savings rates in the world, hitting 33% in 2007-08. End note.), a major portion of it is being invested in gold which does not lead to the creation of a productive asset, he noted. India needs to mobilize more foreign capital investment in productive assets like infrastructure to achieve a sustainable growth rate, he said. On a positive note, Sonal Varma of Nomura Financial Advisors, noted significant changes in investment "inflows" returning to India which reflects a change in investor sentiment.

¶9. (U) According to Varma, India had witnessed the first leg of private-sector capital expenditure (capex) spending during 2006-08. While government spending accounted for most of capex during the last few months during the economic downturn, Aditya Birla Group's Ranade pointed out that private sector capex has started to slowly pick up again. Private sector investments plans are back on schedule, albeit at a slower pace than before, he said. In this context, the need for government spending and investment especially in light of the rising fiscal deficit should be re-evaluated, he argued. Reliance Capital's Sheth agreed that federal government spending should be curtailed in the present circumstances but highlighted state government spending and investment as a beneficial driver of the economic growth of Indian states and pointed to Gujarat as an example.

Illiquidity and Low Volumes in the Debt Market Constrains Long-Term Project Financing

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¶10. (U) Following a discussion on how the U.S. bond market operates and the issue of retail investments in U.S. bonds, Sheth pointed out that where U.S. banks could provide advice is actually (or ironically) in the corporate debt market. Pan of Kotak Mahindra Bank pointed out that India lacked a long term loan structure" - meaning that corporations could not raise any long term funds. Moreover, he noted that India's long-term benchmark paper is infrequently traded. He explained that it was very difficult for a corporation to estimate and benchmark the cost of raising funds for a longer term in India. Most banks have one to three year deposits and only a few have five year deposits. Banks are, therefore, reluctant to lend for longer periods of time, he continued. The development of a long term debt market is, therefore, vital especially for infrastructure projects which have longer gestation periods.

¶11. (U) Pan also highlighted that while government securities have the repo (repurchase) facility, corporate bonds lack these capabilities thereby reducing "liquidity in the paper." Ranade pointed out that it was far more difficult for a bank to sanction a loan rather than invest in a bond. However, banks still prefer to lend rather than invest in bonds, which according to him, does not make sense. Pan pointed out that there is something wrong with how the regulator is dealing with the debt market, and that is why the debt market is so small, with few trades and few participants.

Interdependence of RBI and Finance Ministry Not Necessarily Bad

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¶12. (U) Glekin pointed out that in meetings with the G-20 there had been lots of talk around the issue of independence of government agencies. U.S. Treasury attachi to India asked the group of economists if the government's initiative to create a separate, independent agency for government borrowings was likely any time soon. Ranade said that management of government



debt should be independent of the RBI to allow the regulator complete independence in its monetary policy planning, but does not necessarily have to be separate from the GOI. However he also stated that independence is over-rated. He believes that the institutional framework and the mechanism to direct, formulate and guide the policy should not be questioned, if the end policy is sound. There are allegations about the lack of independence of the RBI and how it is subservient to the Ministry of Finance's fiscal planning but Ranade noted that every government across the world is biased towards running fiscal deficits. He continued that as a democracy, India has one-hundred times more bias to deficit financing to enable government spending on populist programs. Ranade pointed out that most economists had criticized the government's farm loan wavier program and the sixth pay commission hikes at the cost of the fiscal balance. Ironically, these moves helped the economy to grow in difficult times, he argued. Sheth maintained that although the decision making of the RBI and Ministry of Finance may be intertwined and not truly independent, these two agencies worked well together during the global financial crisis.

Inflation Still a Challenge Even With a Low-Interest Rate Regime

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¶13. (U) Interlocutors agreed that India's current bout with deflation in the wholesale price inflex (WPI) index will be short-lived and inflation is still a cause for concern. Nomura Financial Advisors' Varma predicted that inflation will most likely return to 6 percent by next year. Looking at production numbers, she believes that India will witness supply-side inflation. Sheth concurred and pointed out that the source of consumer price inflation in India stems from food shortages as food forms a major part of consumer spending. A food price-driven inflation crisis seems imminent with indications of a less than normal monsoon, and constricted purchasing power, she continued. Ranade concurred and added that the main challenge facing the Reserve Bank of India will be to maintain low prices in a low-interest rate regime or risk high inflation. The conversation came to a close with the group questioning if India would inflate itself out of its deficit.

Comment:

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¶14. (U) There has been an up swell of euphoria, confidence, and high-expectations since the Congress Party-led government was unexpectedly re-elected in the recent national elections with a larger majority. All eyes are on the budget scheduled to be announced on July 6. The new government has a fine line to tread. On one hand, populist programs and sops will endear the government to the common man but would raise the already-ballooning fiscal deficit and could alarm the rising markets. On the other hand, reforms like divestment or raising FDI sectoral caps are exactly what the markets and foreign investors are eagerly awaiting. The Prime Minister and his economic advisers like Montek Singh Ahluwalia appear to understand this delicate balance and their rhetoric is focused on improving delivery of basics like health and education. Luckily, this seems to be increasingly the type of populist programs that many voters are clamoring for. End Comment.
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